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IN THE

Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-303

In the Matter of:

HALLMARK MEDICAL SERVICES, INC., ET AL.,

Debtors

WILLIAM H. MARTIN, *Trustee, Petitioner*

v.

ISAAC MIZRAHI, STEPHEN CRAIR and HEIMAN AND CRARY, P.A., *Respondents.*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

The Petitioner, William H. Martin, Trustee, respectfully prays that a Writ of Certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Fifth Circuit entered in this proceeding on March 15, 1973.

OPINION BELOW

The Opinion of the Court of Appeals appears at 475 F.2d 801 and is appended as Exhibit "A". The denial of the Petition for Rehearing and Petition for Rehearing En Banc is appended as Exhibit "B". The decision of the District Court for the Middle District of Florida, which the Court of Appeals reversed, and the Recommendation of the Special Master, which the District Court confirmed, are appended hereto as Exhibits "C" and "D".

JURISDICTION

The judgment of the Court of Appeals for the Fifth Circuit was entered March 15, 1973. A timely Petition for Rehearing and for Rehearing En Banc was denied on May 18, 1973. A petition for stay of mandate was granted on June 8, 1973 and the issuance of the mandate was stayed to July 8, 1973. This Petition for Certiorari was filed within 90 days of the denial of the Petition for Rehearing. This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1).

QUESTIONS PRESENTED

1. Whether a plan of reorganization under Chapter X of the Bankruptcy Act must, as a judicially-created requirement, include a mandatory "six months" priority classification for private corporations performing quasi-public functions, thereby raising substantial recurrent obstacles to the achievement of successful corporate reorganizations.

2. Whether private nursing home corporations serve a quasi-public function requiring a special mandatory "six months" priority in reorganizations under Chapter X of the Bankruptcy Act.

3. Whether the decision below creating a mandatory "six months" priority class of creditors conflicts with the decisions of other United States Courts of Appeal as to the proper priority of creditors in corporate reorganizations under Chapter X of the Bankruptcy Act.

STATUTORY PROVISIONS INVOLVED

Bankruptcy Act, § 115 (11 U.S.C. § 515):

> Upon the approval of a petition, the court shall have and may, in addition to the jurisdiction,

powers, and duties hereinabove and elsewhere in this chapter conferred and imposed upon it, exercise all the powers, not inconsistent with the provisions of this chapter, which a court of the United States would have if it had appointed a receiver in equity of the property of the debtor on the ground of insolvency or inability to meet its debts as they mature.

Bankruptcy Act, § 197 (11 U.S.C. § 597):

For the purposes of the plan and its acceptance, the judge shall fix the division of creditors and stockholders into classes according to the nature of their respective claims and stock. For the purposes of such classification, the judge shall, if necessary, upon the application of the trustee, the debtor, any creditor, or an indenture trustee, fix a hearing upon notice to the holders of secured claims, the debtor, the trustee, and such other persons as the judge may designate, to determine summarily the value of the security and classify as unsecured the amount in excess of such value.

STATEMENT OF THE CASE

Hallmark Medical Services, Inc. and its subsidiary corporations (hereafter Hallmark) on August 7, 1970 were in the business of building, operating and selling nursing homes for profit in the State of Florida. On that date an involuntary petition for corporate reorganization under Chapter X of the Bankruptcy Act was filed against Hallmark and resisted by the debtors, whose sole stockholders at that time were Mr. and Mrs. John R. Bostrom. No shares were publicly held or registered. On September 6, 1970, while the Petition for Reorganization was pending for decision before the District Court, one Michael Klencz purchased the Bostroms'

stock in the debtors which was purchased the following day by one of the Respondents, Isaac Mizrahi. (44 et seq.)[1] On December 21, 1970, District Judge Ben Krentzman entered an order granting the Petition for Reorganization and appointing the Petitioner, William H. Martin, Trustee. (6-15).

Thereafter, a bar order was entered setting a time for the filing of claims, and proofs of claim were filed by the Respondents. (30-55) Respondent Mizrahi claimed $19,400.00 for loans made by him to Hallmark after the filing of the petition on September 28 and October 9, 1970, and $40,200.00 for loans made by one Samuel Levy to Hallmark on September 9, October 9, October 27, November 20 and November 23, 1970, which loans were assigned to Mr. Mizrahi on February 15, 1971. The Respondent, Heiman and Crary, P.A., claimed $13,250.00 for legal services rendered to Hallmark after the filing of the Petition for Reorganization and while Hallmark was under Mr. Mizrahi's control; and the Respondent Crair claimed $4,235.00 for accounting services rendered to Hallmark after the filing of the petition and while they were under Mr. Mizrahi's control. (1, 30-32).

The Securities and Exchange Commission was notified as required by § 247 of the Bankruptcy Act, received the notifications required by § 265a, but declined under § 173 to express any opinion upon the Trustee's proposed plan of reorganization. (13, 125, 126).

No order was entered by the District Court authorizing loans or guaranteeing the payment of professional services to Hallmark during the pendency of the involuntary reorganization petition.

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[1] All references are to the Appendix filed in the Fifth Circuit.

In due course the Trustee filed an Amended Application to classify creditors and determine solvency (16) and a proposed Plan of Reorganization. (94-120) The Trustee's proposed classification of creditors was (in order of priority):

> "a. The United States with respect to claims for taxes and other debts against said debtors.
>
> b. Any state or political subdivision thereof with respect to claims for taxes against said debtors.
>
> c. Secured creditors of said debtors.
>
> d. Unsecured creditors of said debtors."

At a duly noticed hearing held before the Honorable Alexander L. Paskay, Referee in Bankruptcy sitting as Special Master, on October 28, 1971, the respondents offered oral objections to the classification of creditors including a contention that creditors furnishing credit within six months prior to the appointment of the trustee were entitled to be treated as priority creditors and so classified. (2, 21) No testimony was offered at this hearing. (2) No other creditor objected to classification. On March 2, 1972, the Special Master filed his recommendation that all objections be overruled. The Trustee's motion to confirm these recommendations, and the Respondent's exceptions thereto, were heard by District Judge Ben Krentzman on March 15, 1972. Again no testimony was offered. (3) Judge Krentzman then entered an order classifying creditors in accordance with the Trustee's application and the Special Master's recommendations. (28-29) The recommendations which were adopted and confirmed stated in material part: (21-22)

"The only objection that merits discussion is based on the so-called 'six months rule.' There are no statutory priorities under Chapter X. Section 102 of the Bankruptcy Act expressly excludes the application of Section 64 and the priorities contained therein. Under Section 197, the court has full discretion to classify creditors. The 'six months rule' asserted by the objectors is one that is basically applied in railroad reorganizations. The paramount consideration in the origin of that rule was the public interest in the continuation of public and quasi-public corporations of the type known as public service corporations. The debtors here cannot be considered that type of corporations or businesses. Moreover, assuming but not deciding that the application of the said 'rule' could be discretionary, the equitable considerations are not here present that might in some cases justify the exercise of any such discretion to create such a class of priority creditors.

"Applying the so-called 'six months rule' to the reorganization of private corporations contradicts the Bankruptcy Act's basic policy of allowing unsecured creditors to share equally within their class; does not protect the public interest in public service corporations, effectively obviates other portions of the Bankruptcy Act such as § 60, and as a practical matter could very well preclude many reorganizations. The undersigned does not believe that the drafters of the Bankruptcy Act intended this result; and such a class of priority creditors is not provided for by the Act. Moreover, the weight of authority is convincingly against any such class of creditors for private corporations. Accordingly, it is recommended that the objection based on the 'six months rule' be overruled and that the creditors entitled to priority be determined to be only the United States and the taxing authorities as set forth in classes (a) and (b) of the Trustee's proposed classification***."

Prior to the entry of the order on classification of creditors, other objections to the Trustee's plan raised by the Respondents had been compromised and settled. Incident to this settlement it was agreed that the claims of the Respondents, to the extent that they were unsecured and not priority claims, would be allowed; the Respondents reserved their right to appeal any ruling that they were not priority creditors; but agreed that any such appeal would not affect or delay the acceptance, confirmation and consummation of the Trustee's Plan of Reorganization. (59, 61, 62, 64, 74) The plan was in fact accepted by the creditors, confirmed by the Court, and has now been substantially consummated.

The order on classification rendered by the District Court in Petitioner's favor on March 15, 1972 was reversed by the Court of Appeals on the grounds that, as a matter of law, a nursing home chain performs a quasi-public function; and that an obligatory judge-created six-months priority classification must be established in Chapter X proceedings for every creditor who furnishes credit or supplies within six months of the appointment of the trustee.

REASONS FOR GRANTING THE WRIT

1. *The Decision Below Raises Significant And Recurring Problems Making More Difficult The Achievement Of Successful Corporate Reorganizations By Erroneously Requiring A Plan Of Reorganization Under Chapter X Of The Bankruptcy Act To Include, As A Matter Of Law, A "Six Months" Priority Classification For Creditors Of Private Corporations Performing "Quasi-Public" Functions.*

The Fifth Circuit's decision is a misconstruction of Sections 115 and 197 of the Bankruptcy Act and will vitally and adversely affect many similar cases which are now pending or will be filed hereafter under Chapter X of the Bankruptcy Act.

Essentially, Chapter X is a remedial statute designed to preserve as going concerns when possible those corporations which are financially embarrassed and which are unable to satisfy their obligations. It affords a means whereby the harsh consequences of immediate liquidation may be avoided through a restructuring of the corporate debt or an orderly liquidation in due course after operation by an impartial trustee. Basically, this preservation of the corporate entity as an active concern is deemed beneficial not only to those financially interested in the corporation, but also to the public and the economy as a whole. It is the legislative policy embodied in Chapter X that those corporations, cleansed of their past financial sins, will be permitted to emerge as productive entities or be liquidated in an orderly fashion instead of on the auctioneer's block.

There are no statutory priorities under Chapter X of the Bankruptcy Act. Section 102 of the Bankruptcy Act expressly excludes the application of § 64 and its priorities. However, the Court of Appeals concluded that the equitable powers granted to reorganization courts by § 115 of the Bankruptcy Act required a plan of reorganization of a private corporation under Chapter X, when that corporation performed a "quasi-public function," to include a mandatory "six months" priority for creditors in that class. This interpretation misreads § 115 and directly conflicts with § 197 of the Bankruptcy Act, which gives the reorganization court full discretion

to classify creditors. See *Scherk v. Newton*, 152 F.2d 747 (10 Cir. 1945); *In re Four Seasons Nursing Centers of America, Inc.*, 472 F.2d 747 (10 Cir. 1973). Moreover, this decision will severely hamper the successful achievement of corporate reorganizations nationwide, in that it places upon the debtor corporation a financial burden not intended by Congress nor required by statute or prior case law. It will invite individuals, as in the present case, to buy stock in corporations undergoing involuntary Chapter X proceedings, to loan money to such corporations and to gamble on the corporation's future, knowing they are fully protected without even a court order or review, to the direct detriment of secured and unsecured creditors whom they will displace.

The so-called "six months rule" had its origin in the Federal courts in railroad reorganizations. The paramount consideration in the origin of that rule was the public interest in the continued operation of a "great public work," *Wood v. Guarantee Trust and Safe Deposit Co.*, 128 U.S. 416, 421 (1888), and in the continuing operation of such corporations. This "rule" has had limited extension to certain public and quasi-public corporations holding monopoly or quasi-monopoly positions of the type known as public service corporations. Significantly, while Congress codified the "six months rule" for railroad reorganizations in the Chandler Act, 11 U.S.C. § 205, it refrained from doing so for other corporations by deliberate choice when it later wrote Chapter X. See Analysis of H.R. 12889 containing amendments proposed by the National Bankruptcy Conference, printed for the use of the Committee on the Judiciary, House of Representatives (74th Cong. 2d Session, 1936) at page 74. And special legislation has been enacted by Congress to prevent crippling reposses-

sion of equipment necessary to the operation of shipping, § 116(6) (1968 amendment), railroad, § 77j, and airline, § 116(5), businesses. Likewise, § 177 of the Bankruptcy Act, embodies the special concern of Congress for any "public-utility corporation, subject to the jurisdiction of a commission having regulatory jurisdiction over the debtor . . .," and § 178 provides similar protection for a "public utility corporation, wholly intrastate." No such legislative umbrella has been raised for "quasi-public" corporations and the omission is both significant and intentional.

The "six months rule" is an exception to the general policy of the Bankruptcy Act to effect a prorata distribution of assets among classes of stockholders and creditors. See *Young v. Higbee Co.*, 324 U.S. 204, 210 (1945). Thus, the rationale which serves as a predicate for the application of the "six months rule" to public and quasi-public corporations, based as it is on the public interest in the continuing operation of public service corporations such as transportation systems and utility companies, should not be extended beyond its original purpose and mandatorily applied to private corporations.

The great weight of the modern decisions supports the conclusion that the "six months rule" should not apply to the reorganization of private corporations. See *In re Pusey and Jones Corp.*, 192 F.Supp. 233 (D. Del. 1961), *aff'd*, 295 F.2d 479 (3d Cir. 1961); *In re Warner Coal Corporation*, 83 F.Supp. 961 (N.D.W. Va. 1949), *aff'd sub nom. Wheeling Electric Co. v. Mead*, 177 F.2d 718 (4 Cir. 1949); *In re Chicago Express, Inc.*, 222 F.Supp. 566 (S.D. N.Y. 1963), *aff'd* 332 F.2d 276 (2d Cir. 1964); *In re North Atlantic & Gulf Steamship*

Co., Inc., 200 F.Supp. 818 (S.D. N.Y. 1962), *aff'd sub nom. Schilling v. McAllister Brothers, Inc.*, 310 F.2d 123 (2d Cir. 1962); *In re Yale Express System, Inc.*, 342 F.Supp. 972 (S.D. N.Y. 1972).

The contrary decision of the Fifth Circuit below is predicated on decisions which, with one exception, arose from state court receiverships or non-reorganization federal court proceedings, most of them prior to the adoption of the Chandler Act. The one case decided after the enactment of the Chandler Act in a Chapter X context, on which the Fifth Circuit relies, is the decision in *Dudley v. Mealey*, 147 F.2d 268 (2d Cir. 1945). That case dealt with the reorganization of a hotel company and in dicta recognized a possible discretionary application of the "six months rule," which was undoubtedly suggested by the equities of the situation before that court. The most that the Second Circuit held was that a provision in a plan *permitting* necessities furnished within six months of the filing of the petition to be paid in full was not an abuse of discretion, and did not automatically invalidate the plan of reorganization. This is far from a holding that a "six months rule" is necessarily applicable to the reorganization of all private corporations performing a "quasi-public function." Special categories could have been proposed here by any creditor and could have been adopted in the District Court's *discretion*, §§ 115, 197, 216(5), (6), but were not.

Although under § 115 a court may exercise in corporate reorganizations the equitable powers available in federal equity receiverships, those powers should not be required in all cases to create priorities at variance with the flexible and pragmatic policy underlying Chapter X.

A required application of the "six months rule" to all reorganizations of what a court may deem a "quasi-public" corporation would subvert the Bankruptcy Act's basic policy of allowing unsecured creditors to share equally within their class, and would overreach the basic premise of the "six months rule" which is to protect the public interest in public service corporations. In the absence of action by Congress, it is improper for judge-made obligatory priorities to be created for all Chapter X reorganizations since to do so would supplant the legislative function of Congress. Moreover, as a practical matter, such a ruling may very well preclude many successful reorganizations by the imposition of an accounting burden to determine who shall enjoy the priority and, more importantly, by the substantial exhaustion of most of the monies available for other affected creditors who must approve any proposed plan. § 179. The ruling will obviate other sections of the Bankruptcy Act such as the preference provision of § 60 and will benefit only those creditors who may be on notice to take precautions to obtain adequate security for their advances or credit.

The drafters of Chapter X did not intend this result. The Chandler Act was not a mere codification of the law governing equity receiverships. It was designed to correct abuses and inefficiencies that existed under prior laws. It does not adopt *in toto* any priorities applicable to equity receiverships. When Congress felt that such priorities should be adopted they said so expressly, as in 11 U.S.C. § 205. Cf. *United States v. Key*, 397 U.S. 322, 330 (1970).

By making a "six months" classification obligatory, the Fifth Circuit has put a straight jacket on Chapter X plans of reorganization and has created—where Con-

gress did not—a mandatory class of priority creditors to overlay statutory priorities (such as claims of the United States). To require inclusion of such a class in every plan of reorganization in Chapter X proceedings involving a company that performs a "quasi-public function" will create a chaotic and capricious result, frustrating the uniform application of the Bankruptcy Act. This is so because the Fifth Circuit provided no guidelines as to what is a "quasi-public function" and a financial burden on plans of reorganization that may defeat successful reorganizations in that "priority creditors" so created must now be paid in full before secured and unsecured creditors.

2. *The Decision Below Erroneously Holds That Private Nursing Home Corporations Serve A "Quasi-Public" Function Requiring A Special Mandatory "Six Month's" Priority In Reorganizations Under Chapter X Of The Bankruptcy Act And Frustrates The Uniform Application Of The Bankruptcy Act.*

The district court ruled that the debtors, a private nursing home corporation, serve a "quasi-public" function which is of such public importance that a special rule is mandated to guarantee repayment for any monies or services coming to it within six months of the granting of a petition for its reorganization. It is submitted that nursing home corporations do not serve a "quasi-public" function like that served by other corporations which have been given such a status under prior law.

If the "six months rule" is applicable at all in the reorganization of private corporations, it should be limited to cases where there is a clear public interest in maintaining uninterrupted the business of a corporation which is public or semi-public in character, and where there is a compelling necessity for the continued operation of that business in terms of public interest.

The "rule" has been restricted in the past to public service corporations which occupy monopolistic or oligopolistic positions. Nursing home corporations, on the other hand, are simply another type of business regulated to some extent by the states. They are private, competitive, and provide a function which is duplicated in the same market, with free right of entry, by dozens of similar corporations. The mere fact that an industry may be subject to state regulation is not in itself enough to demonstrate that vital public interest in the continued operation of each individual firm within the industry that must be shown before the "six months rule" can be invoked. If nursing homes perform a "quasi-public" function because they take care of people, for profit, and receive payment indirectly from the federal government through such intermediaries as Blue Cross and Blue Shield, then so does every private hospital and nursing home in the United States. Moreover, this definition would include the hundreds of other private corporations operating for profit which are the beneficiaries of government subsidies or are regulated by government to some extent. Before effective reorganizations under Chapter X can be achieved under the Fifth Circuit decision, the applicability of the rule to every nuance of extent of governmental regulation will have to be litigated. The difficulties attending Chapter X reorganizations can only be exacerbated.

The courts that in recent years have considered this problem have concluded that reorganizations of common carriers, be they water or truck, despite their monopolistic, regulated and subsidized status, are not to be burdened by such a "six months rule." See, *e.g.*, *In re North Atlantic and Gulf Steamship Co., Inc.*, 200 F.Supp. 818 (S.D. N.Y. 1962), *aff'd sub nom. Schilling*

v. McAllister Brothers, Inc., 310 F.2d 123 (2d Cir. 1962); *In re Yale Express System, Inc.*, 342 F.Supp. 972 (S.D. N.Y. 1972). And a Florida appellate court has recently concluded that, as a matter of Florida law, a hospital, though it receives an indirect subsidy through the Medicare program, is not a public or quasi-public institution. *Monyek v. Parkway General Hospital, Inc.*, 273 So.2d 430 (Fla.App. 3d Dist. 1973)

The Fifth Circuit emphasized the fact that Hallmark and its subsidiaries received Medicare payments. However, the Medicare Act, 42 U.S.C. § 1395 et seq., is clear that the making of payments to intermediaries, who pass them to the hospital, does not make private hospitals in any sense governmental institutions or cause them to perform a public function.

The Fifth Circuit below has held as a matter of law, that there is a compelling public necessity for the continued operation of a private nursing home chain, and that its creditors should enjoy a priority status in Chapter X proceedings distinct and superior to the creditors of other private corporations. If such a decision is to be made, it should be by Congress. The public does not have a vital interest in seeing that each and every such business stays in existence. Their competitors are readily able to handle the patient population. There is no factual showing on the record here whatever that the patients in the nursing homes of Hallmark would not have been taken care of by the other area nursing homes or by institutions in the event that Hallmark had not received the appellee's loans during the pendency of the involuntary reorganization petition. Indeed, the entire rationale af the Fifth Circuit's decision could have been as well satisfied by the

appellees' going to the District Judge and obtaining debtor's certificates of indebtedness or other protection for any advances made to the debtor under § 116(2) or § 70(d). If such a course had been followed, the priority created thereby would have been supervised by the court, and unsecured creditors who existed before the six month period, such as the patients of the nursing homes who made deposits on admission, would not have been mandatorily subordinated to the loans of the respondents Mizrahi and Levy simply by virtue of the happenstance that speculative investors felt it worthwhile to make such a loan to a failing corporation. The corporation had little reason or inclination to refuse, especially when the lenders owned the corporation's stock and were the new president and secretary of the business. (33-43).

3. *The Decision Below Conflicts With The Decisions Of Other Federal Courts As To The Proper Priority Of Creditors In Corporate Reorganizations.*

The concept that six months creditors should necessarily and always be treated differently from other of corporations in Chapter X conflicts squarely with the decisions of other federal courts which have concluded that no such separate priority classification should be created. The Third Circuit in the case *In re Pusey & Jones Corp., aff'd,* 295 F.2d 479, 480-481 (3d Cir. 1961) stated:

> "If Deemer's claim is to be upheld for this highly desirable position, any creditor who furnishes goods on credit to, for example, a grocery or drug corporation would be entitled to the same advantage. It is true that Pusey and Jones used these castings to supply customers with whom they had contracts and that the material thus furnished helped keep the business going. But that could also

> be true of the jobber who supplied merchandise to the grocery or drug store. Each must have new supplies to continue as a going concern. We would then have an entirely new class of preferred creditors, namely, those who supply goods to a failing corporation in order to keep it going during the six months prior to reorganization proceedings. And this result would apply with equal force, according to the argument for the appellant, whether the reorganization proceedings are successful or whether the corporation, failing to get a successful reorganization, moves into bankruptcy.
>
> We do not think that this is a good result. The bankruptcy statute has specific provisions concerning the order in which claims are arranged for distribution of a bankrupt's estate. We think it is undesirable to create a new class of creditors by judge-made rules which would transcend the provisions carefully worked out in the bankruptcy act. If a new class of preferred creditors is to be established it should be done by the statute and not by ourselves."

See also the cases cited at pages 9-10 of this Petition, supra. These authorities reason that the "six months rule" should be strictly confined and limited to the purposes which brought it into being; that there is no compelling public interest in maintaining even steamship and motor transport corporations; that the rule was intended to protect public service corporations and not every company which performs a function which the courts may thereafter think beneficent. As stated in *In re Yale Express System,* 342 F.Supp. 972, 974 (S.D. N.Y. 1972):

> "Thus, the courts in this circuit and elsewhere have recognized that even though the six months rule has been allowed to carry over to some extent from

§ 77 to Chapter X proceedings through the exercise of judicial discretion under § 197, it is a rare case where the rule has been applied to ordinary private commercial entities.***Blanket application of this equitable rule in straight reorganization runs counter to the order of priorities and distribution created by the Act and should not be applied generally.***With the exception of one case, the six months rule in this circuit has been limited to cases where there exists a strong public interest in and need for continuing company operations which are public or semi-public in nature. Such enterprises, whether publicly or privately owned, might best be described as natural or quasi-monopolies.

* * *

The one case in this circuit in which the rule has been applied to a private commercial entity in a highly competitive field was Dudley v. Mealey,

* * *

Subsequent cases have indicated that *Dudley* should be limited to its or closely analogous facts."

Without statutory foundation, and in conflict with the courts of other circuits, the Fifth Circuit has removed the discretion and flexibility envisioned by Congress in formulating plans of reorganization by creating an obligatory priority class of creditors in the reorganization of private corporations performing "quasi-public functions." Since no factual hearing directed to this point was held in the trial court, the Fifth Circuit concluded, as a matter of law, that a nursing home does, but a certified steamship or truck line does not, provide such function. This broad edict will have wide consequences, not only in bankruptcy reorganizations, but in such cases as tort law. Because of this conflict and "the matter being of considerable practical importance

to the administration of the Bankruptcy Act," certiorari should be granted. *New York v. Saper,* 336 U.S. 328, 329 (1949).

This decision, however, is most important in that it unnecessarily hampers and may entirely frustrate successful reorganizations. In this day of uncertain business trends, this is an intolerable result. It conflicts with longstanding bankruptcy law and should be reversed.

CONCLUSION

For these reasons a Writ of Certiorari should issue to review the judgment and opinion of the Fifth Circuit.

Respectfully submitted,

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IN THE

United States Court of Appeals

FOR THE FIFTH CIRCUIT

No. 72-2440

In the Matter of: HALLMARK MEDICAL SERVICES, INC., ET AL, Debtors,

ISAAC MIZRAHI, STEPHEN CRAIR and HEIMAN AND CRARY, P.A.,

Appellants,

versus

WILLIAM H. MARTIN, Trustee,

Appellee.

Appeal from the United States District Court for the Middle District of Florida

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(March 15, 1973)

Before WISDOM, BELL and COLEMAN, Circuit Judges.

WISDOM, Circuit Judge: In this case a group of unsecured creditors in a Chapter X bankruptcy seeks priority ranking under the so-called "six months rule." The appellant-creditors contend that this rule allows

EXHIBIT A

priority to all creditors who furnish credit to a corporate debtor within six months before the appointment of a trustee if such credit is necessary to the continued operation of the debtor. The district court, adopting the recommendations of a special master, disallowed the claim of priority of the six months creditors. Because the district court held as a matter of law that no six months class could exist in this case, the creditors here appealing offered no evidence as to what money or services they rendered to the debtor corporation. We hold that the six months rule may apply to Chapter X reorganizations of quasi-public corporations.[1] We remand for a determination whether under principles of equity these creditors qualify for priority classification under that rule.

I.

Hallmark Medical Services, Inc., built, operated, and sold nursing homes for profit. It operated six nursing homes in Florida with beds for 472 patients and also owned several homes under construction which when completed would have a capacity for 620 patients. Hallmark also owned a hospital in Largo, Florida.

On August 7, 1970, the holders of four million dollars of unsecured debentures filed a petition for involuntary corporate reorganization under Chapter X of the Bankruptcy Act. On December 21, 1970, the petition for reor-

[1]Because of reasons stated in this opinion we do not reach the question whether the six months rule applies to purely private corporations.

ganization was granted and a trustee was appointed. Proofs of Claim were filed and a ranking of creditors was established. Several unsecured creditors argued that they were entitled to priority for having extended credit to the corporation within the six month period before the appointment of a trustee.[2] The district court ruled that Hallmark was a purely private corporation and that the six months rule did not apply to the reorganization of private corporations. The court denied the creditors' claims for priority. That conclusion was reached without receipt of any evidence or testimony at the hearing of October 28, 1971, or at the hearing of March 15, 1972. All parties have stipulated that the sole issue on appeal is the applicability of the six months rule to a reorganization under Chapter X of the Bankruptcy Act. No questions of fact are before us.

II

The function of the six months rule is to encourage the extension of credit to corporations delivering important public services at a time when they are financially weak. The end served is to prevent the interruption of services to the public and to preserve the value of the corporate assets for the other creditors. Without the benefit of preferential ranking, unsecured creditors

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[2]The plan of reorganization called for sale of all of Hallmark's assets for over five million dollars. That amount was sufficient to satisfy the claims of the United States, the claims of state and local governments, and the secured creditors in full, but would provide perhaps as little as 33 cents on the dollar for the unsecured creditors. Both the appellants and the debenture holders were unsecured.

would have no motivation to risk venture capital. The costs of labor, supplies, and repairs necessary for the continued operation of the corporation, or capital to purchase those items, have been treated as expenses of administration when they are provided within six months before the appointment of a trustee.

The appellee acknowledges that the rule is applicable to public service corporations but argues that the rule does not necessarily apply to every corporation "affected with the public interest." We conclude that the function, not the characterization, of the corporation and the purpose for the credit are the determining factors.

III.

The six months rule was judicially created and first applied in railroad reorganizations, *Fosdick v. Schall*, 1878, 99 U.S. 235, 25 L.Ed. 339.[3] It was eventually extended to other public and quasi-public corporations

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[3]In refusing to apply the rule to credit extended for original construction, the Supreme Court stated; "The [Fosdick] case lays great emphasis on the consideration that a railroad is a peculiar property, of a public nature, and discharging a great public work. There is a distinction between such a case and that of a purely private concern. We do not undertake to decide the question here, but only to point it out." Wood v. Guarantee Trust & Safe Deposit Co., 1888, 128 U.S. 416, 32 L.Ed. 472 473. In *Wood* the Court also emphasized that the credit was not for operating expenses. The six months rule for railroads has been codified at 11 U.S.C. § 205(c). *Cf.* Johnson v. Fare Box Co. v. Doyle, 2 Cir. 1958, 250 F.2d 656 where the court refused to equate "new equipment" with operating expenses.

providing the public with gas, lighting, telephones, irrigation, heating, and transportation.[4]

The application of the rule, however, has not been confined to public service corporations but has also been applied to private corporations under Chapter X of the Bankruptcy Act, 6 Collier on Bankruptcy § 9.13[5] (14th ed.); 11 Remington, Bankruptcy § 4535 (Rev.ed. 1961). Operating expenses such as salaries, supplies, professional services, and workmen's compensation for private corporations have been included within the ambit of the six months rule.[5]

Judge Learned Hand vividly explained the reason for extending the rule to private corporations:

> ". . . Just as it is recognized that, after insolvency, the expenses of continued operation of a business may be necessary to preserve its value for the secured creditors themselves, and for that reason that the receiver's creditors have priority, so it may be before insolvency.

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[4]In re Madison Railways Co., 7 Cir. 1940, 115 F.2d 586; Crane Co. v. Fidelity Trust Co., 9 Cir. 1916, 239 F. 693; Penn. Steel Co. v. New York City Ry. Co., 2 Cir. 1914, 216 F. 458; Louisville and Nashville RR. Co. v. Memphis Gas Light Co., 6 Cir. 1903, 125 F. 97; Keelyn v. Carolina Mutual Telephone & Telegraph Co., 4 Cir. 1898, 90 F. 29; Reyburn v. Consumers Gas, Fuel, and Light Co., 1887, N.D. Ill. 29 F. 561; 6A Collier on Bankruptcy § 9.13(5) p. 249 (1972).

[5]Bowen v. Hockley, 4 Cir. 1934, 71 F.2d 781; Dickinson v. Saunders, 1 Cir. 1904, 129 F. 16; Olyphant v. St. Louis Ore and Steel Co., 1884, E.D. Mo., 22 F. 179; L'Hote v. Boyet, Miss. 1905, 38 So. 1; Drennen v. Mercantile Trust & Dep. Co., Ala. 1897, 23 So. 164.

> To take the case at bar, upon the continued operation of a hotel its good will depends; let it once shut down, and it will lose much of its value. Unless the tradesmen with whom it must deal can be protected, as its credit slowly wanes before final insolvency, it must begin to trade upon a cash basis, which may be difficult or even impossible. Some priority to them may be essential to the preservation of the business during that period as it is later. While the interests of the public were no doubt the paramount consideration in the origin of the rule, the interests of the lienors themselves may make equally imperative some protection to supply creditors."

Dudley v. Mealey, 2 Cir. 1945, 147 F.2d 268, 271. *Dudley* concluded that services and supplies provided to a hotel within the six month period were entitled to priority. In other cases where the public interest did not demand continued operation of a business and where there was no substantial class of lien-holders whose interests would have been jeopardized had a corporation ceased operation, creditors were denied the priority of six months status.[6] In re *North Atlantic & Gulf Steamship*

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[6]Regardless of equitable considerations, other courts have held that the six month rule cannot in any case apply to a Chapter XI bankruptcy. Priorities in a Chapter XI bankruptcy are determined by § 64 of the Act, 11 U.S.C. § 104 whereas Chapter X priorities are determined by principles of equity under § 115, U.S.C. 515. There are no statutory priorities under Chapter X. Section 102 11 U.S.C. 502 of the Act expressly excludes § 64 ranking. In re Chicago Express, Inc., 2 Cir. 1964, 332 F.2d 276. In Chapter X a court is empowered to classify

Co., Inc., 1962, S.D.N.Y., 200 F.Supp. 818, *aff'd sub. nom., Schilling v. McAllester Bros., Inc.*, 2 Cir. 1962, 310 F.2d 123; *In re Pusey & Jones Corp.*, 3 Cir. 1961, 295 F.2d 479. Thus the rule is applied restrictively, rather than presumptively. *Johnson Fare Box Co. v. Doyle*, 2 Cir. 1958, 250 F.2d 656, 657; *In re Yale Express System, Inc.*, 1972, S.D.N.Y., 342 F.Supp. 972.

IV.

In determining whether a corporation is public or quasi-public it is the function, not the character, of the corporate entity which is significant. Here, Hallmark provided services to 472 patients and was constructing facilities for 620 more. As of December 1971, 298 of Hallmark's patients were classified as "Medicaid skilled" which meant that the patient was seriously ill and required skilled nursing care. The revenue produced from those patients was in fact less than the cost of the serv-

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creditors, § 197, 11 U.S.C. 57. We do not here make any ruling with respect to a Chapter XI proceeding. See also Reading Co. v. Brown, 1968, 391 U.S. 471, 48, 88 S.Ct. 1759, 20 L.Ed.2d 751 (Dissenting opinion of Chief Justice Warren).

Another Chapter XI proceeding where the six month rule was rejected is In re Pusey & Jones Corp., 3 Cir. 1961, 295 F.2d 479, affirming, 1961, D.Del., 192 F. Supp. 233, which involved a paper-making machine company. The rationale of *Pusey* was that this corporation did not serve a vital public interest and that the statute did not expressly allow priority. The court stated: "Considered reflection leads to the view the exception of the six months rule should not be extended to all private corporations." Another case cited by the appellee, but which was decided on the basis of § 64 is In re Warner Coal Corp., 1949, N.D.W.Va., 83 F. Supp. 961, *aff'd sub.nom*, Wheeling Electric Co. v. Mead, 4 Cir. 1949, 177 F.2d 714.

ices provided them.[7] Only 134 of Hallmark's patients were private. The medical expenses of the others were paid by governmental subsidies from various sources including the Division of Family Services of the State of Florida (Medical Assistance for the Needy, Fla.Stat. Ann. 409.266), Medicare (Federal Health Insurance for the Aged, 42 U.S.C. § 1395 et seq.), and Hospital, Domiciliary, and Medical Care for Veterans (38 U.S.C. § 610 et seq.) Furthermore, expert testimony indicated a need for additional nursing homes in central Florida and that the market was underdeveloped.[8] The homes were licensed and regulated by Florida statutes prescribing minimum standards of operation and requiring that inspection be permitted at reasonable times. Fla. Stat. Ann. § 400 et seq. A violation of those state regulations carries criminal penalties. Fla. Stat. Ann. § 400.13.

The closing of these nursing homes would have serious consequences for those under their care. These nursing homes had a direct relation to public health and performed vital public function. It was exigent that these essential therapeutic services would be delivered without interruption.

We conclude that Hallmark performed a quasi-public function that brought it within the ambit of the six

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[7]Hallmark received only $11.60 per day for the Medicaid patients and only $18.75 per day for the Medicare patients whereas private patients paid between $20 and $30 per day. A reduction in the number of beds available could tend to displace the welfare patients.

[8]Findings of Fact, Referee in Bankruptcy, p. 6, October 27, 1970 (Exhibit Q,#18).

months rule. In a Chapter X reorganization, though no statutory priorities exist, a trial judge may equitably apply the six months rule to quasi-public corporations where circumstances justify its application. This conclusion is not inconsistent with the Act's policy of classifying all unsecured creditors together because a justification for priority is that an extension of credit has preserved a larger fund for the other creditors.[9] Having concluded that a six months class may exist for quasi-public corporations we remand the case for further proceedings to enable the district court to determine whether these appellants merit inclusion within the rule. We do not express any opinion whether equity weighs in favor or against these appellants or whether they should properly be classified as six months creditors.

REVERSED and REMANDED for further proceedings consistent with this opinion.

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[9]Compare the policy of this priority with the high ranking lien for salvage in admiralty. Gilmore and Black, The Law of Admiralty, §9-20, p. 514 (1957). The rank is granted because of the "benefit conferred in preserving the value of the ship and cargo."

Adm. Office, U.S. Courts—Scofields' Quality Printers, Inc., N. O., La.

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

October Term, 1972

No. 72-2440

D. C. Docket No. 70-209-BKY-T

In the Matter of:
HALLMARK MEDICAL SERVICES, INC.,
ET AL, Debtors,

ISSAC MIZRAHI, STEPHEN CRAIR and HEIMAN AND CRARY, P.A.,
Appellants,

versus

WILLIAM H. MARTIN, Trustee,
Appellee.

Appeal from the United States District Court for the Middle District of Florida

Before WISDOM, BELL and COLEMAN, Circuit Judges.

J U D G M E N T

This cause came on to be heard on the transcript of the record from the United States District Court for the Middle District of Florida, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be, and the same is hereby, reversed; and that this cause be, and the same is hereby remanded to the said District Court for further proceedings consistent with the opinion of this Court;

It is further ordered that appellee pay to appellants the costs on appeal to be taxed by the Clerk of this Court.

March 15, 1973

Issued as Mandate:

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IN THE

United States Court of Appeals

FOR THE FIFTH CIRCUIT

No. 72-2440

In the Matter of: HALLMARK MEDICAL SERVICES, INC., ET AL, Debtors,

ISAAC MIZRAHI, STEPHEN CRAIR and HEIMAN AND CRARY, P.A.,
Appellants,

versus

WILLIAM H. MARTIN, Trustee,
Appellee.

Appeal from the United States District Court for the Middle District of Florida

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ON PETITION FOR REHEARING AND PETITION FOR REHEARING EN BANC
(Opinion March 15, 1973, 5 Cir., 1973, ____ F.2d ____).

(May 18, 1973)

Before WISDOM, BELL and COLEMAN, Circuit Judges.

EXHIBIT B

PER CURIAM: The Petition for Rehearing is DENIED and no member of this panel nor Judge in regular active service on the Court having requested that the Court be polled on rehearing en banc, (Rule 35 Federal Rules of Appellate Procedure; Local Fifth Circuit Rule 12) the Petition for Rehearing En Banc is DENIED.

Adm. Office, U.S. Courts—Scofields' Quality Printers, Inc., N. O., La.

EXHIBIT C

UNITED STATES DISTRICT COURT
MIDDLE DISTRICT OF FLORIDA
TAMPA DIVISION

In the Matter of	:	
HALLMARK MEDICAL SERVICES, INC., et al.,	:	No. 70-209-Bky-T
Debtors.	:	

ORDER CLASSIFYING CREDITORS

THIS CAUSE came on to be heard pursuant to due notice on the recommendations of the special master dated March 2, 1972, and on the trustee's motion to confirm said recommendations, and due notice having been given to all necessary parties and the Court being fully advised in the premises, it is

ORDERED that:

1. The said recommendations of the special master be and the same are hereby rtaified, approved and confirmed, and are hereby made the findings and conclusions of this Court, and all objections to the trustee's motion be and the same are hereby overruled.

2. For the purposes of the plan of reorganization of the debtors filed herein by William H. Martin, as trustee, and its acceptance, the division of creditors of said debtors into classes according to the nature of their respective claims be and hereby is fixed as follows:

(1) The United States with respect to claims for taxes and other debts against said debtors.

(2) Any state or political subdivisions thereof with respect to claims for taxes against said debtors.

(3) Secured creditors of said debtors.

(4) Unsecured creditors of said debtors.

3. No persons other than those in Classes (1) and (2) above are entitled to be treated as priority creditors.

4. The stockholders need not be classified, as the estate has previously been found by this Court to be insolvent, and therefore no allowance under said plan of reorganization need be given stockholders.

DONE AND ORDERED in Chambers at Ft. Myers, Florida 15 day of March, 1972.

/s/

BEN KRENTZMAN
UNITED STATES DISTRICT JUDGE

EXHIBIT D

UNITED STATES DISTRICT COURT
MIDDLE DISTRICT OF FLORIDA
TAMPA DIVISION

In the Matter of	:	
HALLMARK MEDICAL SERVICES, INC., COASTAL SUPPLY, INC., SOUTHEASTERN CARE CENTERS, INC., HALLMARK NURSING CENTERS, INC. and UPNC, INC,	:	In Proceedings for the Reorganization of Corporations
Debtors.	:	No. 70-209 Bky-T

RECOMMENDATION OF SPECIAL MASTER
RE CLASSIFICATION OF CREDITORS

Alexander L. Paskay, duly appointed Special Master herein, after due notice, on October 28, 1971, heard the amended application to classify creditors and for other relief filed herein by the Trustee, William H. Martin, and after due deliberation respectfully reports as follows:

1. The Trustee, William H. Martin, has served and filed an amended application to classify creditors and for other relief. On September 27, 1971, the Honorable Ben Krentzman, United States District Judge, entered an order setting said application for hearing before the undersigned as Special Master on October 28, 1971, and prescribing the notice in connection with such hearing.

2. Said application requests in part that for the purposes of the Plan of Reorganization filed herein by the Trustee and its acceptance the Court enter an order dividing creditors into the following classes and finding them fair for said purposes:

(a) The United States with respects to claims for taxes and other debts against said debtors

(b) Any state or political subdivision thereof with respect to claims for taxes against said debtors.

(c) Secured creditors of said debtors

(d) Unsecured creditors of said debtors.

3. On October 14, 1971, Judge Krentzman entered an order modifying the order of September 27, 1971 only with regard to the required notice. All necessary notices were given as required.

4. No written objections were filed to said application of the Trustee relative to classification of claims; but at the hearing on October 28, 1971, certain oral objections were made to some aspects of said classification. These objections included contentions that creditors furnishing credit within six months prior to appointment of the Trustee are entitled to be treated as priority creditors; that different secured creditors must be placed in diffrent classes; and that debenture holders should be separately classified. Thereafter the undersigned requested and received memoranda on behalf of the Trustee, the petitioning creditors and the objectors relative to the legal issues involved. The undersigned has now carefully considered these memoranda and recommends that all objections be overruled.

5. The only objection that merits discussion is based on the so-called "six months rule." There are no statutory priorities under Chapter X. Section 102 of the Bankruptcy Act expressly excludes the application of Section 64 and the priorities contained therein. Under Section 197, the Court has full discretion to classify creditors. The "six months rule" asserted by the objectors is one that is basically applied in railroad reorganizations. The paramount consideration in the origin of that rule was the public interest in the continuation of public and quasi-public corporations of the type known

as public service corporations. The debtors here cannot be considered that type of corporations or businesses. Moreover, assuming but not deciding that the application of the said "rule" could be discretionary, the equitable considerations are not here present that might in some cases justify the exercise of any such discretion to create such a class of priority creditors.

Applying the so-called "six months rule" to the reorganization of private corporations contradicts the Bankruptcy Act's basic policy of allowing unsecured creditors to share equally within their class, does not protect the public interest in public service corporations, effectively obviates other portions of the Bankruptcy Act such as § 60, and as a practical matter could very well preclude many reorganizations. The undersigned does not believe that the drafters of the Bankruptcy Act intended this result; and such a class of priority creditors is not provided for by the Act. Moreover, the weight of authority is convincingly against any such class or creditors for private corporations. Accordingly, it is reommended that the objection based on the "six months rule" be overruled, and that the creditors entitled to priority be determined to be only the United States and the taxing authorities as set forth in classes (a) and (b) of the Trustee's proposed classification. See *In Re Pusey & Jones Corporation,* 192 F. Supp. 233 (D. Del. 1961), aff'd 295 F.2d 479 (3 Cir. 1961); *In Re Warner Coal Corporation,* 83 F.Supp. 961 (N.D. W. Va. 1949); aff'd *sub nom, Wheeling Electric Co. vs. Mead,* 177 F.2d 718 (4 Cir. 1949) *In re Chicago Express, Incorporated,* 222 F.Supp. 556 (S.D.N.Y. 1963), aff'd 332 F.2d 276 (2 Cir. 1964); *In Re North Atlantic & Gulf Steamship Co., Inc.,* 200 F.Supp. 818 (S.D.N.Y. 1962), aff'd *sub nom, Schilling vs. McAllister Bros., Inc.* 310 F.2d 123 (2 Cir. 1962).

The Special Master therefore recommends that an order be made and entered herein as follows:

1. Granting the Petition of the Trustee to classify creditors and overruling all objections thereto.

2. Determining that for the purposes of the Plan of Reorganization of the Debtors filed herein by William H. Martin as Trustee, and its acceptance, the division of creditors of said debtors into classes, according to the nature of their respective claims, be fixed as follows and found fair:

(a) The United States of America with respect to claims for taxes and other debts against said debtors.

(b) Any state or political subdivisions thereof with respect to claims for taxes against said debtors.

(c) Secured creditors of said debtors.

(d) Unsecured creditors of said debtors.

3. Determining that no persons other than those in classes (a) and (b) above are entitled to be treated as priority creditors.

4. Determining that stockholders not be classified, as the estate is insolvent, and therefore no allowance under any plan need be made for stockholders.

Respectfully submitted this 2nd day of March, 1972 at Tampa, Florida.

ALEXANDER L. PASKAY
SPECIAL MASTER AND
REFEREE IN BANKRUPTCY